No. 84-1447

Supreme Court, U.S.
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IN THE
Supreme Court of the United States
OCTOBER TERM, 1984

WILLIAM Z. SALCER, *et al.*,
Petitioners,

vs.

ENVICON EQUITIES CORP., *et al.*,
Respondents.

RESPONDENTS' JOINT SUPPLEMENTAL BRIEF IN OPPOSITION TO A PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Respondents Envicon Equities Corp., Envicon Development Corp., Envitex Realty Corp., Venture Development Group, Inc., U.S. Southwest Associates, Turning Block Associates, Feit & Ahrens, William B. Bush, Jr., John W. Galston, Erving Wolf, Harry W. Burrow and Blonder, Seymour & Shapss jointly submit this supplemental brief in opposition to the petition for a writ of certiorari seeking review of the decision of the United States Court of Appeals for the Second Circuit in *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (1984) ("*Salcer*").

After respondents submitted their joint brief in opposition to the certiorari petition, the United States Court of Appeals for the Eighth Circuit issued an *en banc* decision relating to the issues in this proceeding. As set forth be-

low, *Austin v. Loftsgaarden*, ____ F.2d ____, (8th Cir. July 16, 1985) ("*Austin II*") supports respondents' position that this Court should deny the petition for a writ of certiorari in *Salcer*. A copy of this opinion is annexed as part of Appendix A. See p. 1a.

ARGUMENT

AUSTIN II FURTHER DEMONSTRATES THE LIMITED SCOPE OF SALCER AND THAT SALCER CORRECTLY APPLIED SECTION 28(a) OF THE EXCHANGE ACT TO THE ISSUES IN THIS CASE

As set forth in detail in respondents' joint brief submitted in opposition to the petition for a writ of certiorari, this Court should deny the petition because: (1) *Salcer's* holding expressly concerned only a procedural question involving interpretation of Rule 12(f) of the Federal Rules of Civil Procedure; (b) *Salcer* did not conflict with decisions of other circuit courts of appeals; and (c) *Salcer* correctly applied Section 28(a) of the Exchange Act, 28 U.S.C. §78bb(a), to the issues in this case.

In *Salcer*, the Second Circuit held that "[t]his appeal presents a classic example of the principle that a motion to strike [under FRCP 12(f)] should not be granted when there exist material issues that can only be resolved after the facts are known." 744 F.2d at 944. Accordingly, the Second Circuit remanded the case for further proceedings because the record was incomplete, stating "further facts must be obtained before the [tax benefit] issue can definitively be resolved in this case." 744 F.2d at 939. In sharp contrast, unlike *Salcer*, the decisions in *Austin I*, *Austin II*, and *Freschi v. Grand Coal Venture*, ____ F.2d*____, which

*This recent opinion of the Second Circuit is annexed as part of the Appendix. See p. 33a.

also dealt with the tax benefit issue, were each based on an adequate record which was fully developed after a trial on the merits.

In their petition for certiorari, petitioners argued that the circuit courts of appeals were "hopelessly divided" and that the Eighth Circuit Court of Appeals was itself divided over the question of whether tax benefits should be taken into account in computing the amount of damages recoverable in a securities fraud claim involving tax shelters (Petition, 5, 14). In *Austin II,* however, the Eighth Circuit Court of Appeals, *en banc,* rejected the panel decision of the Eighth Circuit in *Hayden v. McDonald,* 742 F.2d 423 (1984) which had held that tax benefits should not be considered in computing damages in an action for actual rescission under state law. (Slip op. at 7. fn.6.) Rather, *Austin II* affirmed the panel decision in *Austin I,* based, in part, on *Salcer.*

Like the Second Circuit in *Salcer,* the Eighth Circuit in *Austin II* distinguished the decision of the Ninth Circuit in *Burgess v. Premier Corp.,* 727 F.2d 826 (1984) based upon the differing nature of the relief sought therein by plaintiffs. Thus, *Austin II* further demonstrats that there is no conflict between the Ninth Circuit, on the one hand, and the Second and Eighth Circuits, on the other hand, concerning the impact of tax benefits in the calculation of damages in tax shelter litigation under the federal securities laws in which the plaintiffs seek recissionary damages.

CONCLUSION

For the reasons stated in this brief and in Respondents' Joint Brief in Opposition, this Court should deny the petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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September, 1985

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 84-5053

Dr. Roger E. Austin,
Dr. Tom W. Anderson,
Dr. Myrel A. Neumann, and
Dr. William C. Randall,

Appellees,

v.

B.J. Loftsgaarden; Alotel Incorporated, a Minnesota corporation; Property Development and Research Company, a Minnesota corporation and 2361 Building Corporation,

Appellants.

No. 84-5058

Dr. Roger F. Austin, Dr. Tom W. Anderson, Dr. Myrel A. Neumann, and Dr. William C. Randall,

Appellees,

Appeals from the United States District Court for the District of Minnesota

v.

B.J. Loftsgaarden; Alotel Incorporated, a Minnesota corporation,

Appellants,

M.S. Noah; John W. Burg; Lyman H. Coult; Robert R. Dunlap

Property Development & Research Company a Minnesota corporation; and 2361 Building Corporation,

Appellants.

No. 84-5059

Dr. Roger E. Austin, Dr. Tom W. Anderson, Dr. Myrel A. Neumann and Dr. William C. Randall,

Appellants,

v.

B.J. Loftsgaarden; Alotel Incorporated, a Minnesota corporation,

Appellees,

M.S. Noah; John W. Burg; Lyman H. Coult; Robert R. Dunlap

Property Development & Research Company a Minnesota corporation; and 2361 Building Corporation,

Appellees.

Submitted: January 17, 1985
Filed: July 16, 1985

Before LAY, Chief Judge, and HEANEY, BRIGHT, ROSS, McMILLIAN, ARNOLD, JOHN R. GIBSON, FAGG, and BOWMAN, Circuit Judges.

PER CURIAM.

This en banc hearing arises from a retrial on the issue of damages ordered by this Court in *Austin v. Loftsgaarden,* 675 F.2d 168 (8th Cir. 1982) (*Austin I*). In *Austin I,* we affirmed the jury's verdict that Loftsgaarden and three of his closely-held corporations (hereinafter Loftsgaarden) violated state and federal securities laws, but held that the district court erred in ruling that the plaintiff-investors' rescissionary damages could not be reduced by the "tax shelter"[1] benefits they received as a result of their in-

[1]In *Austin I,* we defined "tax shelters" as investments which allow the investor

> to offset certain "artificial losses" (that is, noneconomic losses but losses which are available as deductions under the present tax laws) not only against the income from

vestments. Thereafter, we denied plaintiffs' petition for rehearing or rehearing en banc.

On remand, the district court deducted plaintiffs' tax benefits from their damage awards and both sides appeal. After oral argument before a panel of this Court, the panel issued an order setting two issues for an en banc consideration: First, whether *Austin I* should be reconsidered as it relates to the offset of tax benefits from rescissionary damages awarded in a private securities fraud action involving an investment that was structured and marketed as a tax shelter; and second, assuming that *Austin I* was properly decided, what is the proper measure of plaintiffs' rescissionary damages?

FACTS.

The facts in this case are set forth in detail in *Austin I,* 675 F.2d at 173-76. We briefly review them here.

Plaintiffs Austin, Anderson, Neumann and Randall, invested over $152,000 in Alotel Associates (hereinafter Associates), a limited partnership organized by defendant B.J. Loftsgaarden to help finance the building and operation of a Ramada Inn in Rochester, Minnesota. Loftsgaarden's offering memorandum claimed that purchasers of the limited partnership interests would receive substantial tax benefits during the first three years of their investments and thereafter would share in the hotel's projected profits.

> those investments but also against the [investor's] other income, usually from his regular business or professional activity.

675 F.2d at 183 (citing Staff of Joint Comm. on Internal Revenue Taxation, 94th Cong., 1st Sess., *Overview of Tax Shelters* 1 (Comm. Print 1975)).

The Rochester Ramada opened several months behind schedule in 1974 at a construction cost substantially in excess of that projected. Thereafter, the hotel incurred significant operating losses and Loftsgaarden requested the limited partners to extend to Associates several large loans to prevent insolvency. The limited partners hired a lawyer and an accountant to investigate Loftsgaarden's stewardship of the project, which revealed that Loftsgaarden had knowingly committed several frauds on the limited partners. Although Loftsgaarden resigned as general partner and the limited partners made additional loans,[2] the partnership ultimately defaulted on its obligations and the hotel was foreclosed upon.

The four plaintiffs[3] then filed this securities fraud action against Loftsgaarden. The jury found that Loftsgaarden had violated "section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); Rule 10b-5, 17 C.F.R. § 240.10b-5; the antifraud provision of the Minnesota Securities Act, Minn. Stat. §§ 80A.01, *et seq.*, 80A.23; and [had committed] common law fraud. The jury rendered an advisory verdict — in which the district court concurred — that defendants were liable for violating § 12(2) of the Securities Act of 1933. 15 U.S.C. § 771(2)." *Austin I,* 675 F.2d at 172 (footnotes omitted). The court applied a rescissionary measure of damages in the amount of the consideration each plaintiff paid for his limited partnership unit or units, prejudgment interest from the date of purchase, and attorneys' fees for plaintifs Randall and Neumann for a total judgment of $273,720.

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[2]The jury found that these advances were not induced by any misrepresentations by Loftsgaarden and thus the plaintiffs could not recover them.

[3]The numerous other limited partners were initially parties to this action but subsequently dropped their claims.

We affirmed the findings of liability, but vacated the award of damages and remanded to the district court, stating "the court committed reversible error in refusing to allow proof of any economic benefits received by plaintiffs on account of the investment and in failing to instruct the jury that the damage award must be reduced by any value shown to have been received by plaintiffs." *Austin I,* 675 F.2d at 181.

On remand, the district court awarded to plaintiffs damages in the amount of their consideration paid, with eight percent interest thereon, less tax benefits received, for a total amount as follows: Anderson, $35,172; Austin, $31,277; Neumann, $39,371; and Randall, $31,569. It also granted attorneys' fees under Minn. Stat. § 80A.23, subd. 2 as follows: Anderson, $0; Austin, $0; Neuman, $29,000; and Randall, $20,000. In addition, the court granted costs of $5,321.83 to Austin, Anderson and Neumann and $2,955.49 to Randall. We now consider the two issues raised before the Court en banc.

DISCUSSION.

I. Should Austin I be reconsidered as it relates to the offset of tax benefits from rescissionary damages awarded in a private securities fraud action involving an investment structured and marketed as a "tax shelter"?

The starting point for our analysis is that the petition for rehearing or rehearing en banc in *Austin I* was denied, 675 F.2d at 168, and that, accordingly, its holdings are now law of the case. As we stated in *Otten v. Stonewall Ins. Co.,* 538 F.2d 210 (8th Cir. 1978):

> Law of the case principles have been stated with clarity and consistency in this court over a

> long pericd of time. "This court has repeatedly held that the decision on former appeal is the 'law of the case' on a question presented in that former appeal, unless the evidence introduced at the subsequent trial is substantially different from that considered on the first appeal, and must be followed in all subsequent proceedings in such case in both district and appellate courts unless that decision is clearly erroneous and works manifest injustice. * * * While this rule of practice is not a limit of power, it is nevertheless a salutary one, and should be departed from only after careful consideration of situations arising in specific cases."

Id. at 212 (citations omitted).

The appellees contend that the damages holding in *Austin I* is "clearly erroneous" and works a "manifest injustice" and thus should be reversed. After a careful review of *Austin I*, the relevant cases, the arguments of the parties and the Tax Division of the Justice Department and the Securities and Exchange Commission, appearing as *amicus curiae*, we abide by our previous decision. In doing so, we note that since our opinion in *Austin I*, the United States Court of Appeals for the Second Circuit has substantially adopted the views that we expressed in that case. *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984).[4]

Our decision in *Austin I* was based on the principle that: "[D]amages for securities fraud are determined in accordance with the extent to which false and misleading information actually harmed the complaining party." *Austin I*,

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[4] *But cf. Burgess v. Premier Corp.*, 727 F.2d 826 (9th Cir. 1984) (applying different rule in case of actual rescission).

675 F.2d at 180 (citation omitted). We noted that for this reason, the courts typically use the out-of-pocket measure of damages,[5] but that where a rescissionary measure of damages is applied, the "actual damages principle requires that a rescissionary * * * award be reduced by any value received as a result of the fraudulent transaction." *Austin I*, 625 F.2d at 181 (citation omitted). We held that this principle applied not only to the 1933 Act claims and the claim under Minn. Stat. § 80A.23(2),[6] (both of which ex-

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[5]The parties are in dispute over whether the out-of-pocket measure of damages would provide recovery similar to that approved here. *See Salcer*, 744 F.2d at 940 n.5, Brief of SEC at 22-23. We need not address this issue, however. *Austin I* limited its holding to tax shelter cases where a rescissionary measure of damages is applied. 675 F.2d at 183.

[6]In *Hayden v. McDonald*, 742 F.2d 423 (8th Cir. 1984), plaintiffs brought claims under Minn. Stat. § 80A.23(1), which provides that, in an action for rescission and restitution based on the nonregistration of securities in Minnesota, "the purchaser shall be entitled to recover the consideration paid for the security * * * less the amount of any income received on the security." Because the Minnesota courts had not directly addressed the issue, we deferred to the district court's interpretation of "income received" as not including tax benefits. *Id.* at 440-41. We now overrule that decision.

We do not believe that Minnesota could have intended to treat fraudulent sellers more kindly than those who have simply neglected to register their securities. Although the phrase "actual damages" does not appear in subsection (1), the principle that a plaintiff should not be placed in a better position than he would have been in but for the fraud — the principle, in other words, that no recovery in excess of actual damages should be permitted — is plainly implicit in that provision. In actions for rescission based on sales of unregistered securities, the statute says, "the amount of any income received on the securities" is to be subtracted from "the consideration paid for the security together with interest" in computing damages.

Moreover, to allow greater recoveries under subsection (1) than under subsection (2) leads to results that are anomalous in the extreme. Subsection (1) governs not only simple actions for sale of unregistered securities (arising under Minn. Stat. §80A.08), but also actions for misrepresenting that registration of a security means that

plicitly limit damages to the "actual damages" sustained), but also to the common law fraud claim[7] and the claim

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state officials are recommending that security (a practice made unlawful by Minn. Stat. §80A.18). Otherwise, a defendant who tells a buyer that the filing of a registration statement means that the Commissioner of Commerce is recommending purchase of the security registered would be liable for the full amount of consideration paid, and would receive no credit for tax benefits conferred on the buyer, however substantial. But a defendant who commits some other kind of fraud, however flagrant, would receive such credit, solely because the action against him arises under §80A.23(2) instead of §80A.23(1). The Minnesota Supreme Court, of course, can resolve this matter authoritatively and have the last word on the subject.

Our brother Heaney, *post* p. 26, takes the position that "it is bad policy" to reach the *Hayden* issue because it "was not presented to us by the parties" and "we need not decide" it. We would like to explain briefly why we disagree with this statement. The Court en banc was convened to decide whether we should adhere to the panel's decision in *Austin I.* Plaintiffs, seeking disapproval of *Austin I,* argued that it was inconsistent with *Hayden.* We agree. The logical implications of *Austin I,* which is now approved by the Court en banc, are completely inconsistent with *Hayden,* for reasons we have given. The Court en banc is convened infrequently, though perhaps not infrequently enough, and we believe it is good judicial policy to use those infrequent occasions to bring consistency to our case law. If we were to leave *Hayden* on the books, without indicating one way or the other whether it is still good law, we would almost guarantee that the Court en banc would have to meet again when the *Hayden* issue arose, unless, of course, the Supreme Court of Minnesota had, in the meantime, resolved the question, an event the likelihood of which we have no way of estimating. For these reasons, we believe it is a wise use of the Court's time and energy to say now that *Hayden* is inconsistent with the position we now take in *Austin II,* and, therefore, to state unequivocally that *Hayden* is abandoned.

[7]In *Berg v. Xerxes-Southdale Office Bldg. Co.,* 290 N.W.2d 612, 615 (Minn. 1980), the Court implied that tax benefits must be considered in determining damages under a Minnesota common law securities fraud claim, at least where the case involves a limited partnership offering which includes the promise of artificial tax savings. 290 N.W.2d at 615-16. *See* note 4, *supra. See also Weise v. Red Owl Stores, Inc.,* 286 Minn. 199, 175 N.W.2d 184, 187 (1970) (the out-of-pocket rule also governs an award of damges for common law securities fraud).

under section 12(2) of the 1934 Act. Although the 1934 Act does not explicitly limit rescissionary damages to "actual damages" sustained, we noted that:

> Under § 12(2), the defendant guilty of prospectus fraud shall be liable to plaintiff, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, *less the amount of any income received thereon,* upon the tender of such security, or for damages if he no longer owns the security.

Id. at 181 (emphasis in original).

Because we found that section 12(2) implicitly incorporates the "actual damages" principle and that the words "income received" should be construed as including the tax benefits bargained for and received in the special case of a tax shelter investment, we concluded that the plaintiffs' damages must be reduced by the tax benefits they received.

The plaintiffs now contend that we should reconsider both of the above findings of *Austin I.* First, they argue that the "actual damages" language in section 28(a) of the 1934 Act does not justify subtracting tax benefits from awards under section 12(2) of the 1933 Act because section 28(a) applies only to the 1934 Act and the words "actual damages" do not appear anywhere within the 1933 Act. We reject this contention. Although the words "actual damages" do not appear in the 1933 Act, the courts have nonetheless applied the actual damages principle of section 28(a) to bar punitive damages[8] under section 17(a) of

[8]We reject the SEC's argument that the actual damages principle is only intended to prohibit awards of punitive damages or duplicate state and federal recoveries based on the same conduct. *See also Shapiro v. Midwest Rubber Reclaiming Co.*, 626 F.2d 63, 70 (8th Cir. 1980), *7 cert. denied,* 499 U.S. 1079 (1981).

the 1933 Act, *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1278, 1283-86 (2d Cir.), *cert. denied*, 397 U.S. 913 (1970), and have construed the rescission and restitution remedy provided by section 12(2) as substantially equivalent to the damages permitted under section 28(a). *Cf. Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972). The goal of rescission under section 12(2) is to return the parties to the status quo *ante*, "and hence a plaintiff can recover no more than his or her 'net economic loss,' " *i.e.*, "actual damages." *Salcer*, 744 F.2d at 940; *Austin I*, 675 F.2d at 181; *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 49 n.22 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978);

We also reject plaintiffs' contention that tax savings are neither "income" nor are they "received" within the meaning of section 12(2). They cite *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975) in support of their argument, but that case is inapposite. The plaintiffs in *United Housing* were tenants who were required to purchase refundable non-interest bearing shares in a non-profit housing cooperative in order to rent a low-cost apartment. After a rent increase was imposed to meet costs, plaintiffs brought fraud claims under the Securities Act of 1933 and the Securities Exchange Act of 1934, alleging that they were misled in the purchase of the shares by misrepresentation in the cooperative's information bulletin. The Court looked to "economic reality," 421 U.S. at 848, in determining that the shares were not securities. It noted that the plaintiffs' purchase of the shares was motivated by a desire to obtain housing, not to make a profit in the sense of a "return on investment." The Court was not persuaded that the plaintiffs expected a profit on their non-interest bearing refundable shares (which were akin to a "security deposit") simply because they were able

to reduce their taxes by deducting that portion of their monthly rental charges which were applied to interest on the mortgage. 421 U.S. at 855. The Court noted that "[e]ven if the tax deductions were considered profits, they would not be the type associated with a security investment since they do not result from the managerial efforts of others." *Id.* 421 U.S. at 856 n.20.

United Housing is not only distinguishable on its facts; if anything, its analysis tends to support our position in *Austin I.* Like the *United Housing* Court, the *Austin I* Court looked to "economic reality" in considering the tax aspects of a tax shelter investment.[9] Additionally, unlike the marginal tax benefits referred to in *United Housing,* the tax benefits in the case at hand were a primary motivation behind the investment and resulted from Loftsgaarden's efforts in structuring and operating the partnership to take advantage of relatively complicated tax rules. *See Salcer,* 744 F.2d at 941 ("plaintiffs' argument that defendants are not entitled to 'credit' for the tax benefits because the latter were 'provided' by the government rather than by the defendants must be rejected * * * [T]hat the tax benefits were paid by the government rather than by the defendants does not lessen the defendants' role in securing them.").

In any event, *Austin I* did not hold that tax benefits re-

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[9]*See also Salcer,* 744 F.2d at 941 ("To ignore the sizeable tax benefits actually realized by the plaintiffs would be unrealistic."); *Bridgen v. Scott,* 456 F. Supp. 1048, 1061 (S.D. Tex. 1978) ("Requiring the jury or this Court to try this case without reference to the tax consequences of the transaction would be requiring the jury and this Court to live in an artificial 'never-never' land. The plaintiffs' position that the tax consequences of this transaction should be ignored is simply not realistic and is tantamount to requesting this Court and the jury to try this case blindfolded.").

ceived are a form of income in a strict accounting sense.[10] Rather, we held that section 12(2)'s requirement that "income received" be deducted in determining rescissionary damages simply reflected that all economic benefits bargained for and received must be deducted from plaintiffs' damages because "the strictly compensatory nature of damages awarded in private securities fraud actions requires that such value be taken into account in determining whether and to what extent damages were inflicted upon plaintiffs." *Austin I*, 675 F.2d at 183.

The plaintiffs claim that their tax benefits have not been "received" must also be rejected because they have stipulated that they have received permanent tax benefits from their investments in Associates. Similarly, we reject the contention of the Tax Division and the SEC that plaintiffs' tax benefits "may" prove to be illusory because they "may" experience recapture upon sale or other disposition of the hotel. All of the plaintiffs in this case have already experienced all possible recapture when the hotel was foreclosed upon in 1978. We also reject, as without a factual basis, the Tax Division's claim that "it is far from clear that all the proper income recognition and recapture provisions were taken into account." Brief of Tax Division at 11. All of the plaintiffs' tax returns from the relevant tax years have already been audited and are now closed.

We also find without merit the Tax Division's claim that, under the "tax benefit rule," the plaintiffs, upon receiving rescissionary damages, will have to amend their prior tax returns to eliminate all tax benefits previously received as a result of their investments in Associates. The

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[10]Loftsgaarden, in an apparent change in strategy, now contends that the tax benefits are not income received but are instead a return of consideration. We address this claim *infra*.

"tax benefit rule" does not require elimination of tax benefits already received. *See Hayden v. McDonald,* 742 F.2d at 440. Rather, it provides that a taxpayer who claims a deduction resulting in a tax benefit one year and who later obtains a recovery or repayment in a later year must include the recovery or repayment as ordinary income in the year of recovery.[11] *See Hillsboro National Bank v. Commissioner,* 460 U.S. 370, 103 S. Ct. 1134, 75 L.Ed.2d 130, 142-44 (1983); *Salcer,* 744 F.2d at 943; 1 Mertens, *Law of Federal Income Taxation,* § 7.34 at 7-115, § 7.37 at 7-130. We need not address the contention of the Tax Division and the SEC that the tax consequences of the rescissionary award will "wash out" any prior tax savings, because we are not presented with such a situation in this case.

The plaintiffs next contend, with support from the SEC, that the collateral source rule requires that Section 12(2) awards not be reduced by tax benefits. This rule "prohibits taking into consideration benefits received from third parties as the result of wholly separate and distinct transactions, such as those received under insurance policies negotiated independently." *Salcer,* 744 F.2d at 941. We agree with the *Salcer* Court that the tax benefits of plaintiffs' investments are not a collateral source because "although paid by the government, [they] emanate directly from the tax shelter sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award." *Id.* at 941-42.

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[11] We need not decide whether a different situation might exist in a case involving actual rescission. *See Salcer,* 744 F.2d at 943; *Burgess v. Premier Corp.,* 727 F.2d at 838.

For similar reasons, we reject plaintiffs' claim that we should ignore their tax benefits because otherwise the defendants will unjustly "retain" the consideration previously paid by the plaintiffs. First of all, it does not appear that the defendant has "retained" any of plaintiffs' consideration; rather these monies were paid to the partnership and were invested in the project. Moreover, the purpose of the private civil remedies provided by the federal and relevant Minnesota securities laws is not to penalize defendants, but to compensate plaintiffs for any actual monetary loss. *See id.* at 941. This actual monetary loss cannot be determined without reference to tax benefits bargained for and received.

We also reject the similar argument of *amici* that deducting tax benefits from damages will deprive the government of just tax revenues. The government is entitled only to those revenues which are authorized under the tax laws. These laws create incentives for real estate projects to further public policy objectives, such as the creation of employment, enhancement of the real estate tax base and the local business climate. The Rochester Ramada project met all of the tax code criteria and thus generated the income tax benefits which the plaintiffs enjoyed. This case is therefore very similar to *Salcer,* where the Court stated:

> Nor can we agree with the notion that our ruling makes "the government the banker for fraudulent tax shelter activity," *Burgess v. Premier Corp., supra,* 727 F.2d at 838. As Judge Broderick noted, there was no such activity in this case; the fraud, if any, pertained only to the investment aspects of the Greenspoint Project. The government got the residential development that it hoped to encourage by offering the tax benefits

> taken by the plaintiffs. Thus, it is "banking" precisely what it agreed to "bank." There is no suggestion that the project did not meet federal requirements as a viable housing development entitling its owners to tax benefits.

Id. at 941.

There is no legal justification for awarding a party damages to which he is not entitled merely to provide revenue for the government to tax.

Next, we reject plaintiffs' claim that the consideration of tax benefits in determining rescissionary damages in a tax shelter case creates unnecessary complexities. Our opinion in *Austin I,* 675 F.2d at 183, deals at length with this contention. We noted that "the complexity of evidence relating to plaintiffs' tax savings is not a viable reason for precluding such evidence in light of *Norfolk & Western R. Co. v. Liepelt,* 444 U.S. 490, 100 S. Ct. 755, 62 L.Ed.2d 689 (1980)." *Id.* We cannot agree that the retrial of the damages issue on remand reflects such complexity that *Austin I* must now be reversed.

Finally, plaintiffs and the SEC[12] contend that *Austin I's* tax benefit offset rule discourages private enforcement of the antifraud provisions of the federal securities laws in an area in which the Commission itself is unable to devote substantial resources.[13] While it is unclear that this will be

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[12]The SEC also argues that tax benefits should be considered in computing prejudgment interest, but not in computing damages. We agree with the *Salcer* Court, 744 F.2d at 942, that this argument "is so unrealistic and disproportionate as to border on the frivolous" and "must be rejected out of hand."

[13]Most tax shelter securities are sold in private offerings exempt from the registration requirements of the 1933 Act.

the result of the offset rule because most defrauded tax shelter investors will still be able to obtain at least some damages, we agree with the *Salcer* Court that it is for the legislature, not for the courts, to authorize the award of more than "actual damages" in order to encourage the filing of private damage actions. *Salcer,* at 941. *See also e.g., Alyeska Pipeline Service Co. v. Wilderness Society,* 421 U.S. 420 (1975) (shifting of attorneys' fees by court to create incentives is impermissible).

In sum, we affirm the holding of *Austin I* "that in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor via tax savings must be permitted." *Austin I,* 675 F.2d at 183-84.

II. How should the plaintiffs' rescissory damages be computed?

On remand, the district court first determined the amount of permanent tax benefits received by each of the plaintiffs as follows: Anderson, $29,615.00; Austin, $33,330.00; Neumann, $57,014.00; Randall, $36,404.00. The parties do not contest this finding; accordingly, we adopt these figurese as the amount of tax benefits received by each plaintiff.

The court then determined that each plaintiff was entitled to prejudgment interest at the rate of eight percent simple interest[14] under section 12(2) of the 1933 Act. The interest rate has been approved by the panel opinion announced today along with the *en banc* opinion.

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[14]The court originally ordered compound interest but amended its judgment by ordering simple interest.

The court then determined rescissory damages in accordance with the specific language of section 12(2): "consideration paid for such security with interest thereon less the amount of any income received thereon." Under the district court's amended determination, this computation produced the following results:

Plaintiff Austin

Consideration paid June 6,1973:	$35,000
Simple interest at 8% to February 22, 1984:	$31,277
Subtotal	$64,610
Minus tax benefits:	– $33,333
Total damages:	$31,177

Plaintiff Neumann

Consideration paid August 21, 1973:	$35,000
Plus consideration paid October 19,1973:	$17,500
Simple interest at 8% to February 22, 1984:	$43,885
Subtotal	$96,385
Minus tax benefits:	– $57,014
Total damages:	$39,371

Plaintiff Randall

Consideration paid November 13, 1973:	$35,000
Simple interest at 8% to February 22, 1984:	$28,770
Plus consideration paid 1975:	$ 2,512
Simple interest at 8% to February 22, 1984:	$ 1,691
Subtotal	$67,973
Minus tax benefits:	– $36,404
Total damages	$31,569

Plaintiff Anderson

Consideration paid June 2, 1973:	$35,000
Plus interest at 8% to February 22, 1984:	$29,787
Subtotal	$64,787
Minus tax benefits:	– $29,615
Total damages	$35,172

Although the parties and *amici* suggest several variations from this damage computation formula, we believe they raise only three serious contentions. First, defendant Loftsgaarden argues that, under the section 12(2) damage computation formula, tax benefits are a return of "consideration paid" and thus must be deducted from consideration paid before adding on interest. As the district court noted, this course would drastically reduce the awards to Anderson and Austin and eliminate the awards to Neumann and Randall. We agree with the district court that this approach must be rejected. As we noted previously, *Austin I* did not indicate that tax benefits should be treated as a return of consideration. Instead, in holding that tax savings must be subtracted from damages we quoted section 12(2) and italicized the phrase, *"less the amount of any income received thereon." Austin I,* 675 F.2d at 181. Similarly, in *Hayden v. McDonald,* 742 F.2d at 441, we characterized *Austin I* as "implicitly construing the 'income' language in a federal securities statute to include tax considerations." At least one commentator has also characterized *Austin I* as "classifying tax benefits received by the plaintiff as 'income' within the meaning of section 12(2) of the 1933 Act." Note, *Austin v. Loftsgaarden, etc.,* 16 Creighton L. Rev. 1140, 1151 (1983). *Cf.* S. Banoff, *"To What Extent Will Benefits From Tax Shelters Be Permitted to Offset Rescission Damages?,"* 57 J. Tax'n 154, 156 (1980).

Additionally, whether or not tax benefits may be considered "income" in a strict accounting sense, tax benefits are far more dissimilar to "consideration." Moreover, although we find that section 12(2)'s language "income *received* thereon" may properly be construed as including tax benefits bargained for and received, we do not agree that tax benefits can be considered a "return" of consideration.

Finally, treating tax benefits as consideration returned would, even under Loftsgaarden's calculations, mean that the plaintiffs would not be compensated for their actual damages. For example, using Loftsgaarden's calculations of plaintiff Neumann's net interest cost (as we explain further below), he would receive no damages even though he suffered net economic loss of at least $992.[15] Loftsgaarden no doubt prefers the zero judgment figure to the $992 figure, in part because this would lend substantial support to his argument before the panel that Neumann is not entitled to the $29,000 in attorneys' fees granted by the district court. In short, we cannot agree that the district court erred in refusing to treat the tax benefits as a return of consideration for purposes of determining the order of computation under the formula set forth in section 12(2).

Loftsgaarden next contends that the district court erred in awarding prejudgment interest on the total amount of

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[15]Loftsgaarden's calculations indicate that Neumann invested $52,500, lost $5,506 in opportunity cost on the use of his money at 8% simple interest and received $57,014 in tax benefits for a net economic loss of $992. But subtracting the $57,014 in tax savings from the $52,500 consideration paid, before considering Neumann's opportunity cost in that he did not receive the $57,014 back until several years after he invested the $52,500, Neumann receives zero in damages.

Loftsgaarden cites *Johns Hopkins University v. Hutton*, 297 F. Supp. 1165, 1233 (D. Md. 1968), *aff'd in part and rev'd in part on other grounds*, 422 F.2d 1124 (4th Cir. 1970) as support, but that case is inapposite. In that case, the court treated "repayment of *principal*" as a return of consideration. A repayment of principal bears no similarity to tax benefits received. However, even if we were to change *Austin I's* rationale and treat tax benefits as a return of consideration, plaintiffs at minimum would be entitled to their net opportunity cost in damages. This could be done by reducing the amount of the tax benefits received to present value at the time of the investment using, for purposes of this opinion, the 8% discount rate. We prefer, however, to affirm the district court's treatment of tax benefits as "income received."

consideration paid by each plaintiff from the date paid until February 22, 1984, rather than awarding interest only on the amount of money which each plaintiff was "out-of-pocket" during each year of the investment. We agree. The goal of prejudgment interest is to compensate plaintiffs for the loss of the use of their money. *See Cant v. A.C. Becker & Co.*, 384 F. Supp. 814 (N.D. Ill. 1974); *Chris-Craft Industries, Inc. v. Piper Aircrafter Corp.*, 384 F. Supp. 507, 527 (S.D. N.Y. 1974), *modified*, 516 F.2d 172 (2d Cir. 1975), *rev'd on other grounds*, 430 U.S. 1 (1977). Because plaintiffs were not deprived of the use of the entire amount of their investments over the ten year period, prejudgment interest is due only on the amount of money they were out-of-pocket at any given time. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1307 (2d Cir. 1973) (prejudgment interest should be computed on the "net difference between value of assets given and value received"); *Murphy v. Cady*, 30 F. Supp. 466, 470 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940) (reaching similar result by determining that plaintiff was entitled under section 12(2) "to recover the amount paid for [the security] with interest, less the amount received with interest").

Loftsgaarden has submitted what we find is a reasonably accurate determination of the net interest costs incurred by the plaintiffs taking into account the amount of money invested, and the tax benefits received by each plaintiff during each year of their investment in Associates. These calculations, prepared by John M. Carlson, Certified Public Accountant, are as follows:[16]

[16]These calculations are based on the eight percent rate affirmed by the panel opinion attached at the end of this opinion. These calculations take into account recapture and also net out plaintiffs' interest costs by their interest gains on the amount of ordinary income above the amount of their investments retained in each year because of tax

RANDALL

	Invested	Net Reduction (increase in) Tax Liability Current	Carryback	Balance	Days	Interest Cost (earned) at 8% annum
11/13/73	35,000			35,000	153	1,174
4/15/74		4,499		30,501	365	2,440
4/15/75		21,268		9,233	365	739
4/15/76		10,481		(1,248)	365	(100)
4/15/77		10,272		(11,520)	365	(922)
4/15/78		7,297		(18,817)	365	(1,505)
4/15/79		(21,855)		3,038	365	243
4/15/80		4,442		(1,404)	1,339	(412)
12/15/83	35,000	36,404		(1,404)	3,682	1,657

ANDERSON

6/2/73	35,000			35,000	317	2,432
4/15/74		11,221		23,779	365	1,902
4/15/75		17,149		6,630	365	530
4/15/76		10,987		(4,357	365	(349)
4/15/77		11,011		(15.368)	365	(1,229)
4/15/78		7,972		(25,340)	365	(1,867)
4/15/79		(35,974)		12,634)	365	1,011
4/15/80		7,249		5,386	1,339	1,580
12/15/83	35,000	29,615		5,385	3,846	4,010

benfits conferred by their investments in Associates. These calculations also assume that each plaintiff did not receive the tax benefits until April 15 of each year, when their tax returns were due. Although this does not take into account the benefits of potential reduced payments of estimated tax, we find that the calculations present a reasonably accurate and straightforward method of determining net prejudgment interest costs.

NEUMANN

8/21/73	35,000			35,000	58	445
10/19/73	17,500			52,000	178	2,048
4/15/74		19,560		32,940	365	2,635
4/15/75		9,848		23,092	365	1,847
7/15/75			3,677	19,415	91	387
4/15/76		14,431		4,984	274	299
4/15/77		4,888		96	365	8
7/15/77			77	19	91	
4/15/78		9,000		(8,981)	274	(539)
4/15/79		(5,263)		(3,745)	365	(299)
4/15/80		769		(4,514)	1,339	(1,325)
12/15/83	52,500	53,260	3,754	(4,514)	3,765	5,506

AUSTIN

6/26/73	35,000			35,000	293	2,248
4/15/74		13,066		21,934	365	1,755
4/15/75		19,259		2,675	365	214
4/15/76		10,863		(8,188)	365	(655)
4/15/77		3,324		(11,512)	365	(921)
4/15/78		7,646		(19,158)	365	(1,533)
4/15/79		(26,274)		7,116	365	569
4/15/80		5,449		1,667	1,339	489
12/15/83	35,000	33,333		1,667	3,822	2,166

SUMMARY

	Invested +	Interest Cost −	Tax Benefit =	Damages and Interest
Randall	35,000	1,657	36,404	253
Anderson	35,000	4,010	29,657	9,395
Neumann	52,500	5,506	57,014	992
Austin	35,000	2,166	33,333	3,833

Next, both plaintiffs and defendants contend that in order for the plaintiffs to be truly made whole, and to be returned to the status quo ante, both the tax benefits received *and* the tax consequences of their recovery must be taken into account. *Dicta* in *Hayden v. McDonald,* 742

F.2d 423, 440 (8th Cir. 1984) supports this contention, and, as the parties are in agreement, we agree that the tax consequences of plaintiffs' recovery must be considered. The parties disagree on how these tax consequences should be determined. We find Loftsgaarden's method to be reasonably accurate and much simpler than plaintiffs' formula and thus adopt Loftsgaarden's method. This method, which was also used in the "Reardon Report," which was cited in *Hayden,* takes into account the fact that, because each plaintiff will have to pay taxes on his award, the award must be calculated in an amount which each plaintiff would have to recover in order to "net out" their actual damage figure. We assume that each plaintiff is still in the fifty percent tax bracket and thus must receive twice the above amount of damages and net interest cost. Thus, in accordance with the panel's affirmance of the eight percent simple interest rate, each plaintiff is entitled to a damage award as follows: Anderson ($9,395 x 2 = $18,790); Austin ($3,833 x 2 = $7,666); Neumann ($992 x 2 = $1,984); Randall ($253 x 2 = $506).

In conclusion, the Court *en banc* affirms *Austin I* but vacates and modifies the district court's award of damages as set forth above.

There are three remaining issues which were initially heard by a panel of this Court. These issues are: (1) Whether the district court, on remand, erred in its interpretation of *Austin I;* (2) whether attorney fees should have been awarded; and (3) whether prejudgment interest was properly calculated. For convenience, the panel's opinion is incorporated herein:

Before LAY, Chief Judge, and ROSS and McMILLIAN, Circuit Judges.

Plaintiffs urge, on cross-appeal, that the district court should have allowed them to retry their case on the "out of pocket" damages theory. At the original trial the district court noted that "out of pocket" and rescissionary damages are essentially the same. However, plaintiffs hoped to avoid the *Austin I* mandate to consider tax benefits by changing to the "out of pocket" approach. On remand, the district court refused to allow the change in theories. We find no error. The plaintiffs tendered their shares to defendants shortly before the original trial and effectively elected the remedy of rescission. More importantly, plaintiffs should not be allowed to introduce a new theory some eight years later. The case is now in its second appeal, after two trials, both of which focused on rescissionary damages. We think it too late to change theories and find no abuse of discretion by either trial judge.

Plaintiffs also argue that *Austin I* applies only to investments "expressly structured and marketed as a tax shelter." *Austin I,* 675 F.2d at 183. According to plaintiffs no factual finding has ever been made that this particular investment was expressly structured and marketed as a tax shelter. The *Austin I* court defined a tax shelter as any investment which creates tax deductions through "artificial losses." *Id.* The court en banc has endorsed that definition. *Austin II,* slip op. at 3. The evidence shows plaintiffs were able to reduce their tax liability significantly in the first few years of the investment through accelerated depreciation and other deductions.

There are several contentions relating to attorney fees. Defendants contend Neumann and Randall failed to prove a cause of action which would support any award of fees and, even if they did, the amount awarded was excessive. Plaintiffs argue that the fees awarded were insufficient

and, furthermore, that fees should have been awarded to Austin and Anderson.

First, the method of damage calculation determined by the court en banc makes it clear Neumann and Randall were damaged and proved a claim for relief. We find the award of fees to Neumann and Randall falls within the range of discretion of the district court. In weighing the arguments we find no abuse of discretion.

Second, plaintiffs cannot recover fees under federal securities statutes. The award to Neumann and Randall was based on Minn. Stat. § 80A.23(2) (1984). This statute was not in effect before August 1, 1973. It is clear from the record that Anderson and Austin purchased their securities prior to that date. Under these circumstances the district court was correct in holding that Anderson and Austin were barred from recovery of attorney fees.

The issue of the method of calculating interest has been resolved by the court en banc. Plaintiffs have argued that the rate, eight percent, was too low. Defendants, on the other hand, argue no interest can be awarded to Neumann and Randall because they suffered no actual damage and thus failed to prove a cause of action. As noted previously, the court en banc's method of damage calculation shows Neumann and Randall did suffer damage and proved a cause of action. While the district court, on remand, was not bound by the original trial judge's use of eight percent as the rate of interest, plaintiffs point to no evidence in the record which would suggest a higher rate. Although we believe the rate of interest should be based on a finding of fact from evidentiary proof, in the absence of such proof we feel the district court did not err in applying an eight percent rate as a traditional and fair rate of interest.

The panel holds that the district court, on remand, correctly interpreted *Austin I* and did not err or abuse its discretion in the award of attorney fees and pre-judgment interest. In conclusion, we remand to the district court for entry of judgment as set forth in this opinion.

HEANEY, Circuit Judge, concurring and dissenting.

I concur in the majority's opinion except insofar as it overrules *Hayden v. McDonald,* 742 F.2d 423 (8th Cir. 1984). I continue to believe that the issue is a doubtful one and that in cases of doubt we should give great weight to a decision of a United States District Court interpreting a statute of the state in which it sits. Moreover, I think it is bad policy to reach an issue that was not presented to us by the parties and which we need not decide.

LAY, Chief Judge, dissenting, joined by BRIGHT, Circuit Judge.

I incorporate my concurrence in *Hayden v. McDonald,* 742 F.2d 423, 441-42 (8th Cir. 1984), and the reasoning set forth therein for urging that tax benefits of plaintiffs in a rescissionary damage action have no relationship to their present claim. The Department of Justice and the Securities and Exchange Commission have presented strong arguments against appellants' theory in amicae briefs.

The majority invokes the doctrine of law of the case. As Judge Learned Hand observed many years ago: "[I]t is now well settled that the 'law of the case' does not rigidly bind a court to its former decisions, but is only addressed to its good sense." *Higgins v. California Prune & Apricot Grower, Inc.,* 3 F.2d 896, 898 (2d Cir. 1924). A court should never be constrained by the weight of a prior er-

roneous decision. The purpose of an en banc hearing is to draw on the wisdom of the full court and rectify earlier errors. Reliance on precedent is a poor substitute for analysis.

The damages provisions of the federal statute, section 12(2) of the Securities Act of 1933, 15 U.S.C. § 771(2), and the Minnesota statute, Minn. Stat. § 80A.23(1), are quite similar:

> § 12(2): * * * recover the consideration paid for such security with interest thereon, less the amount of any income received thereon * * *.
>
> § 80A.23(1): * * * recover the consideration paid for the security together with interest at the legal rate, costs, and reasonable attorney's fees, less the amount of any income received on the securities.

The key words are "less the amount of any income received * * *." The majority concedes that the tax benefits received by plaintiffs are not really "income." Nonetheless, the court holds the benefits must be subtracted — notwithstanding the clear language of the statute — in order to give meaning to "actual income." As Judge Arnold notes in his concurrence, the present holding as to Minnesota law cannot be rationally squared with *Hayden*.

Loftsgaarden relies heavily on *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), *cert. pending*. The *Salcer* court was concerned the plaintiff might receive a windfall and, like the majority today, applied the tax benefits in favor of the defendant, transferring any possible windfall to the wrongdoer. The Ninth Circuit has held to the contrary, using the same reasoning I urge this court to adopt. *Burgess v. Premier Corp.*, 727 F.2d 826, 837-38

(9th Cir. 1984). The *Burgess* court found that "to simply subtract the tax benefits from damages would place an unfair burden on taxpayers generally. * * * Such a result leaves the government bearing the cost of defendants' fraud." *Id.* at 838. *See also Western Federal Corp. v. Erickson,* 739 F.2d 1439, 1444 (9th Cir. 1984).

Application of tax benefits to lessen damages in a rescissionary suit actually fails to comprehend the principle behind a "tax shelter." The investor receives no money from the tax benefit; the investor simply is allowed to deduct a certain amount from his ordinary income or apply a credit toward tax owed for the particular tax year. The actual value of the benefit depends on the income bracket the investor is in, which in turn depends on other deductions that may be available to the taxpayer that year. This fact alone demonstrates how speculative any benefit in tax savings may be. More significantly, the tax benefit is not a real or actual savings – it is usually only a deferral of tax. Ultimately, in a time of recapture when the investment is sold or otherwise disposed of, the taxpayer must return to the government tax benefits gained unless the investor suffers an actual loss. The court's conversion of the tax deferral to realized income by subtracting it from a plaintiff's damages provides a windfall to the defendant – the fraudulent party. The holding in this case violates the old principle that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." *Janigan v. Taylor,* 344 F.2d 781, 786 (1st Cir.), *cert. denied,* 382 U.S. 879 (1965), *quoted in Myzel v. Fields,* 386 F.2d 718, 747 (8th Cir. 1967), *cert. denied,* 390 U.S. 951 (1968).

In mitigation, the majority believes Loftsgaarden did not benefit from any of the consideration paid by plain-

tiffs. This is patently wrong. There was evidence at trial showing Loftsgaarden received over $100,000 profit from the investment scheme. Under the majority's approach, Loftsgaarden gains both his own profit from the scheme and the advantage of plaintiffs' speculative tax benefits. Such a result seriously undercuts the broad protective purpose of the Securities Act of 1933. *See United States v. Naftalin,* 441 U.S. 768, 774-777 (1979).

The majority adopts the magnanimous suggestion in Loftsgaarden's brief that, in all fairness, plaintiffs' ultimate damages should be doubled in order to offset the tax consequences of recovery – assuming plaintiffs are in the fifty percent bracket. This serves to demonstrate how speculative and inaccurate the consideration of tax consequences can be in a suit involving rescissionary damages. A defendant should not have to pay damges based on the plaintiff's tax bracket in a given year. This is not a damage caused by the defendant. Their theory is that to make plaintiffs whole and restore the status quo ante we must account for the tax treatment of plaintiffs' recovery. However, the relevant statutes clearly require the court to restore the consideration paid to the defrauding party, with interest, less any income actually received from the investment. And tax benefits concededly are not income received from the investment! Consideration of tax benefits involves the court in the problems of recapture and net gains or losses. In turn, the court finds it must consider each plaintiff's income and deductions in the year of recovery to net out "actual damages" based on applicable tax rates. Rather than making up an artificial

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[1] If depreciation deductions were actually "income," then every taxpayer who takes such a deduction would have to include it as gross income on the next year's tax return, rather than applying it to the property's basis.

theory of damage by doubling the net gain, it is much simpler and more accurate to provide the plaintiff with restitution of his investment. The statutes provide a clear and simple formula. For example, Anderson invested $35,000 for a period of seven years. Loftsgaarden paid Anderson no interest or dividends and returned no principal. Anderson should recover $35,000 with interest for those seven years. Anderson will have to pay tax on the interest at ordinary income rates. In addition, he may be required to recapture past benefits. The tax transaction is between Anderson and the government and should not affect Loftsgaarden's liability. By this method a plaintiff recovers exactly what he lost: the principal, and interest he would have earned had that principal been invested in a legitimate security.[2] This procedure is far more simple than requiring trial courts to undertake complicated and speculative evidentiary hearings on the mechanics of tax deferral plans and plaintiffs' tax status in given years of investment.

Today's holding provides the wrongdoer a surety by which to avoid liability, allowing the fraudulent party to use the United States Treasury for security in any fraudulent transaction. To the extent a defendant can, by his wrongful act, create a tax loss for the innocent victim, the defendant will be allowed to escape liability, shifting the burden of the loss onto the government. I do not believe

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[2]It is reasonable to assume that if plaintiffs had not invested in Loftsgaarden's fraudulent scheme, they would have invested in another legitimate project which would have returned similar tax benefits as well as principal and interest over the life of the investment. The majority's approach will not make plaintiffs truely whole because the tax benefits are subtracted from the return of principal and interest.

section 12(2) or section 80A.23(1) was designed to accomplish this result. Accordingly, I dissent.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 487, 509, 611 — August Term, 1984

(Argued: January 9, 1985 Decided: July 5, 1985)

Docket Nos. 84-7726, 84-7740, 84-7764

WILLIAM FRESCHI, JR., as Trustee of WILLIAM FRESCHI TRUST,

Plaintiff-Appellee, Cross-Appellant,

—v.—

GRAND COAL VENTURE, BANDLER & KASS, GROUND PRODUCTION CORPORATION, WILLIAM J. WERNER, JACK MITNICK, ROBERT SYLVOR, WILLIAM C. SHERR, MINERAL RESOURCES DEVELOPMENT, INC. and H. JEAN BAKER,

Defendants,

GRAND COAL VENTURE, BANDLER & KASS, GROUND PRODUCTION CORPORATION, WILLIAM J. WERNER, JACK MITNICK, ROBERT SYLVOR, H. JEAN BAKER and WILLIAM SHERR,

Defendants-Appellants, Cross-Appellees.

Before:

MANSFIELD, NEWMAN, and PECK,* *Circuit Judges.*

* Of the Sixth Circuit Court of Appeals, sitting by designation.

Appeal from a judgment of the District Court for the Southern District of New York (Robert W. Sweet, Judge) holding defendants Ground Production Corporation, Bandler & Kass, Werner, Mitnick, Sylvor, Sherr and Baker liable for Rule 10b-5 violations, and defendants Ground Production Corporation, Bandler & Kass, Werner, Mitnick, Sylvor, and Baker liable for fraud, and awarding $266,500 in damages, plus pre-judgment interest.

Finding of liability as to Mitnick on 10b-5 count reversed; other findings of liability affirmed; damages reduced to $77,818; remanded for further proceedings.

Neil Schwarzfeld, New York, N.Y. (Alan C. Fried, Schwarzfeld, Ganfer, Shore & Rosenblum, New York, N.Y. on the brief), for defendants-appellants, cross-appellees.

Robert C. Gerrard, Boston, Mass. (Edward N. Perry, Bowker, Elmes, Perkins, Mecsas & Gerrard, Boston, Mass. on the brief), for plaintiff-appellee, cross-appellant.

JOHN W. PECK, *Circuit Judge:*

This is a securities fraud case. Following a jury trial, defendants Ground Production Corporation, Bandler & Kass, William J. Werner, Robert Sylvor, William C. Sherr, H. Jean Baker, and Jack Mitnick, appellants herein,[1] were found liable for violation of Securities and Exchange Commission Rule 10b-5, and all defendants except

[1] The briefs list Grand Coal Venture as a defendant-appellant. Grand Coal Venture, an unincorporated entity, was named as a defendant; there was, however, no finding of liability against it, and it is therefore not a party to the appeal.

Sherr were found liable for common law fraud as well. They were ordered to pay plaintiff-appellee William Freschi, Jr., trustee of the William Freschi trust, $266,500 in damages, plus $126,681.75 in pre-judgment interest. *Freshchi* v. *Grand Coal Venture*, 588 F. Supp. 1257 (S.D. N.Y. 1984). Defendants have appealed, and Freschi has cross-appealed. We affirm the trial court's judgment of liability as to all defendants except Mitnick; the judgment against him is reversed as to Rule 10b-5 but affirmed as to fraud. We also partially reverse the award of damages on the basis of our decision in *William Z. Salcer, Panfeld, Edelman* v. *Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), which had not yet been decided when judgment was entered by the district court.

I.

A.

The events leading to this trial began in the summer of 1977, when William Freschi, Sr., the father of plaintiff-appellant, decided to seek a tax shelter for $2,700,000 he had realized from the sale of his interest in a business. Accordingly, he established a trust with his son, William Freschi, Jr. ("Freschi"), as trustee. Freschi decided to invest the trust corpus, which consisted principally of the funds realized from the sale of the business, in operations paying a moderate to high rate of return while offering substantial tax benefits.

A securities salesman suggested that Freschi invest in Spruce Productions, Inc., a venture being organized by appellants Werner, Sylvor, and Sherr. Werner, Sylvor, and Sherr were partners in a law firm, Bandler & Kass, which represented an entrepreneur, Joseph Laird, who was under investigation by the Securities and Exchange

Commission ("SEC") for marketing of fraudulent coal leases. Knowing that the SEC "wanted to put Laird out of business," the three partners decided to take Laird's place in marketing the leases if Laird were forced to cease marketing them. The partners began doing so, through an entity called Spruce Productions, Inc., at least as early as December 1, 1977. The Spruce Productions prospectus contained an express warranty that, if the leased property did not contain recoverable coal reserves, the sponsors of the offering would provide substitute property that did contain such reserves. In the prospectus, the sponsors also promised to buy at least 25% of the coal mined at a profit to the investor and to provide free legal representation to investors in the event that IRS disallowed projected tax deductions. On December 8, 1977, with the mutual consent of the SEC, Laird, and other parties not involved in this suit, the United States District Court for the Central District of California issued a temporary restraining order. The order barred Laird and certain other parties, including his attorneys, from marketing unregistered coal leases to the public. *Securities and Exchange Commission* v. *Cal-Am Corp.*, No. 77-4586 (C.D. Cal. Dec. 8, 1977) (T.R.O.) Werner was personally served with a copy of the order on December 14, 1977.

At this time, Freschi had already decided to invest in Spruce Productions.[2] Werner, Sylvor, and Sherr were

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[2] Freschi wrote a check for $130,000 made out to "Bandler & Kass, Special Account" on December 12, 1977. With it he enclosed a handwritten signed note to "Mr. Werner," stating that the check was "to sub lease [sic] coal land and to obtain an advance royalty payment writeoff [sic]." Freschi held the check, however, until December 19; at this time he mailed it to an agent in New York, who tendered the check to Bandler & Kass under circumstances detailed below.

aware of the difficulty in accepting his investment without violating the T.R.O., but wished to find a way around the problem. As a result, they decided to scrap Spruce Productions and to replace it with another entity offering substantially the same leases through dummy corporations, thus avoiding the T.R.O.'s bar on sales to the public. Werner thus informed Freschi, in a December 15, 1977 telephone conversation, that the Spruce Productions offering was being withdrawn, but would be replaced by a very similar offering. The reason for the change, Werner told Freschi, was that he had just met with IRS officials and it had proved necessary to revise the offering to conform with new IRS regulations. No such meeting with IRS officials, in fact, had occurred.

Werner, Sylvor, and Sherr then formed a company known as Ground Production Corporation. Ground Production procured Laird's coal leases from a new company called Tristar Coal Corporation, which we conclude Laird had formed in an attempt to circumvent the T.R.O. Werner, Sylvor, and Sherr also formed an unincorporated organization known as Grand Coal Venture, which in turn obtained coal leaseholds from Ground Production. To assist them in their work, Werner, Sylvor and Sherr hired H. Jean Baker, a self-styled "geologist" without formal training in geology. Baker, a former associate of Laird's, signed a report stating that there was a strong likelihood that the leased lands contained large coal reserves.

Freschi, relying on the previous assurances that the Grand Coal Venture offering was essentially the same as the earlier Spruce Productions offering, took steps to invest in Grand Coal Venture. At this point, no one had told Freschi of Laird's difficulties with the SEC or of the

temporary restraining order; Freschi's assumption was that Werner had truthfully told him the deal was being restructured due to tax problems. Freschi took independent action to verify the soundness of the projected investment. He consulted an accountant, had the trust's attorney call Werner to discuss the deal and its tax consequences, and retained an agent to verify that Bandler & Kass was a reputable law firm. This agent was satisfied by his investigation, and acting on behalf of Freschi, tendered a check for $130,000 of the trust's funds to Bandler & Kass as the first installment of payments to Grand Coal Venture which eventually were to total $266,500. This first payment was made on December 21, 1977; the documents evidencing the trust's investment were dated December 29, 1977.

Freschi did not receive Grand Coal Venture's offering memorandum until March 31, 1978. This memorandum revealed that, in spite of Werner's earlier assurances about the similarity between the Grand Coal Venture offering and the Spruce Productions one, there were some rather significant differences. Most significantly, the Grand Coal Venture offering lacked the assurances the earlier offering had contained about the profitability of the venture, and indeed contained specific caveats as to the riskiness of the investment. The memorandum, which was a long and complex document (totalling 167 pages), also contained what appeared to be substantial similarities to the Spruce Productions offering: it dealt with coal leases in the same general region, it contained figures at the outset purporting to set forth the "total minimum" return on the investment, and, most importantly, to Freschi, it offered the same tax advantages as had the original offering. The memorandum also incorporated Baker's optimistic "geologist's report."

Upon receiving the memorandum, Freschi began a further investigation designed to insure that his investment was a viable one. His investigation included consultations with his accountant, his attorney, Sherr, a coal mining executive, an attorney specializing in coal leases, and a geologist, who accompanied Freschi to a meeting with Baker. The investigation took place over a period of three months and involved trips from Freschi's home in San Francisco to New York and Denver as well as communications by telephone and mail. Nothing in this rather thorough investigation suggested to Freschi that he was the victim of fraud.

In August, 1978, Jack Mitnick, who acted as "Venture Administrator" for Grand Coal Venture, sent investors a letter, drafted by Sylvor, stating that the leased land did not contain commercially recoverable quantities of coal. The letter further stated, however, that Grand Coal Venture's sublease from Ground Production contained an express warranty that Ground Production would, under such circumstances, give Grand Coal Venture replacement leases containing commercially recoverable coal reserves—a statement which was not true. "Accordingly," the letter continued, "demand has been made of Ground that it immediately furnish you with suitable subleases . . . containing economically recoverable coal reserves . . ." Ground Production actually did give Grand Coal Venture a replacement lease, similarly worthless, in December 1978. Mitnick and Werner continued to assure Freschi that all was well at regular intervals through December 1980. The trust, however, never received any profits on its investment. Finally, Freschi, his patience exhausted, filed the instant suit on July 13, 1981, in the United States District Court for the Southern District of New York.

B.

Freschi was, as we have noted, interested in Grand Coal Venture largely as a tax shelter. At the time of his investment, the tax laws offered large deductions for coal mining investments, as part of a national policy of developing American energy self-sufficiency.

Because Freschi's father was the sole beneficiary of the trust, the trust was not a separate taxpaying entity; all taxes on trust income were assessed directly against the senior Freschi, but paid from the trust corpus. Freschi's father claimed tax deductions for Grand Coal Venture of $320,000 in both 1977 and 1978. These deductions reduced his tax bill for the two years by $337,033.66 and $322,813.01, respectively. IRS ultimately disallowed these deductions and assessed a deficiency against the senior Freschi. It also assessed an interest penalty of approximately $264,500. IRS eventually allowed the senior Freschi, however, to claim a deduction for 1977 for his $266,500 lost investment. This deduction resulted in total federal and state tax savings for the elder Freschi of $188,682. Thus Freschi's actual out-of-pocket loss on his investment was $77,818; because of the failure of his tax shelter he was required to pay IRS $639,846.67 on account of the disallowed deductions, plus the $264,500 interest penalty.

C.

Freschi's suit against Grand Coal Venture and its various principals and agents was tried before a jury in May 1984.[*] The jury returned a special verdict form

[*] Prior to trial, the court dealt with various motions; *inter alia*, the court denied Freschi leave to amend his complaint to add a

[Footnote continued on following page]

finding all defendants liable to Freschi, both directly and as aiders and abettors, for violations of Rule 10b-5; all defendants except Sherr liable to Freschi for state law fraud; and Bandler & Kass, Werner, Sylvor, and Sherr liable to him for legal malpractice. The jury awarded damages of $440,000 on the legal malpractice claim. For the Rule 10b-5 and state fraud violations, the jury awarded combined damages of $926,346.07, "plus all expenses incurred in both this action and actions before the tax courts plus interest due IRS on any deficiencies, including plaintiff's attorneys' fees." The jury further "suggested" that part of the damage award "be held in some type of escrow account" and awarded only if Freschi, who was challenging the IRS deficiency assessment, ultimately suffered the full tax losses he claimed. On a motion by the defendants, the trial judge rendered judgment non obstante veredicto on the legal malpractice count, and, disallowing that part of the award based on increased tax liability, offered Freschi remittitur of the remaining damage award from $926,346.07 to $266,500, the amount of his investment, plus pre-judgment interest of $126,681.75. Freschi accepted the remittitur offer. Defendants filed a timely appeal to this court, and Freschi filed a timely cross-appeal.[4]

[Footnote continued from previous page]

cause of action under the Organized Crime Control Act of 1970 ("RICO"), Pub L. 91-457, 84 Stat. 941, 18 U.S.C. § 1961 *et seq.* *Freschi v. Grand Coal Venture*, 583 F. Supp. 780, 787-88 (S.D.N.Y. 1984). At the close of the evidence and before submission of the case to the jury, the court directed a verdict for defendants on a breach of contract cause of action.

[4] Because Freschi accepted the trial court's offer of remittitur, he conditioned his cross-appeal on this court's altering the remittitur offer.

II.

A.

The first issue we must address is whether the findings of liability against all appellants on the 10b-5 count, and against all appellants except Sherr on the state law fraud count, can stand. Appellants argue that Freschi's claim against them on these counts was barred by California's three-year statute of limitations for fraud when Freschi filed the action in July 1981.

Freschi and the appellants agree that the three-year California statute of limitations for fraud governs both the fraud and the Rule 10b-5 causes of action.[5] They also agree that the causes of action accrued when Freschi discovered the alleged violations or should, upon reasonable inquiry, have discovered them.[6] *Arneil* v. *Ramsey*, 550 F.2d 774, 780 (2d Cir. 1977); *Korn* v. *Merrill*, 403 F. Supp. 377, 387 (S.D.N.Y. 1975), *aff'd*, 538 F.2d 310 (2d Cir. 1976).[7] They disagree, however, on the crucial issue

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[5] Rule 10b-5, like many federal causes of action, has no express statute of limitations. Accordingly, the federal courts adopt the most analogous state statute of limitations. Both parties agreed that the statute of limitations for fraud was the most analogous limitations statute, and further agreed that the law of the forum state, New York, would apply the limitations statute of California, the state of plaintiff Freschi's residence.

[6] While the federal courts adopt the analogous state staute of limitations in 10b-5 actions, the time at which the plaintiff's cause of action accrues is a question of federal law. *See, e.g., Phillips* v. *Levie*, 593 F.2d 459, 462 (2d Cir. 1979); *Arneil* v. *Ramsey*, 550 F.2d 774, 780 (2d Cir. 1977).

[7] A long series of cases establishes the need for due diligence on the part of a plaintiff in order to toll a statute of limitations for fraud. *See, e.g., Bailey* v. *Glover*, 88 U.S. (21 Wall.) 342, 348-49 (1874); *Robertson* v. *Seidman & Seidman*, 609 F.2d 583, 585 (2d Cir. 1979); *Phillips* v. *Levie*, 593 F.2d 459, 462 (2d Cir. 1979); *Berry Petroleum Co.* v. *Adams & Peck*, 518 F.2d 402, 410 (2d Cir. 1975).

of when Freschi should have discovered, upon reasonable inquiry, that he was the victim of a fraud. Appellants assert that he should have become aware of this fact on March 31, 1978, when he received the Grand Coal Venture offering memorandum which, they allege, stated terms materially different from those which he had thought governed his investment. If this claim is accepted, the finding of liability must be reversed, as Freschi's time for bringing suit would have expired over three months before he filed suit in July 1981.

The question was submitted by the trial court as a question of fact to the jury, which returned a finding that the three-year statute of limitations did not bar the suit. Appellants do not contend that the trial court erred by submitting the question to the jury as one of fact; we must review this question as one of fact, and can reverse only if we conclude that the jury's finding was not supported by any substantial evidence.

We conclude that there was substantial evidence to support this jury finding, and therefore we affirm it. We have already detailed the rather painstaking investigation Freschi undertook on receiving the offering memorandum. While it is possible that some investors might have undertaken an even more through investigation, there was substantial evidence for the jury to find that this investigation satisfied the requirement of due diligence, and therefore to find that the statute of limitations did not bar the claim.

We note that the trial court's charge to the jury with regard to the statute of limitations, while correct in most particulars, placed the burden of proving that Freschi failed to exercise diligence on the defendants. The burden

ought to have been on Freschi as plaintiff to prove his diligence as the prerequisite to allowing equitable tolling of the limitations statute. *See, e.g., City of Detroit* v. *Grinnell Corp.*, 495 F.2d 448, 461 (2d Cir. 1974); *Long* v. *Abbott Mortgage Corp.*, 459 F. Supp. 108, 116 (D. Conn. 1978). Defendants, however, did not object to this aspect of the instructions at trial, and have not, in fact, raised it as an issue on appeal. We are not convinced that the trial judge's instruction in this regard was such plain error as to warrant reversal in the absence of an objection, timely or otherwise, by the parties arguably harmed [1] by the instruction. *See* Fed. R. Civ. P. 51.

B.

Having concluded that Freschi's suit was not barred by the applicable statute of limitations, we now proceed to consider whether defendants' conduct contained the elements of common law fraud and of Rule 10b-5 violations. In doing so, we first consider the elements of each cause of action, and then consider separately whether each party was properly found liable.

SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, states:

> § 240.10b-5 Employment of manipulative and deceptive devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality

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[1] We say "arguably harmed" because we are not persuaded that the instruction constituted anything more than harmless error, given the evidence for the exercise of due diligence on Freschi's part. Because we base our decision on this point on the lack of an objection, it is unnecessary, however, for us to decide whether the instruction did constitute harmless error, and we refrain from doing so.

of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Thus a 10b-5 violation has two essential elements, the use of the mail, an instrumentality of interstate commerce, or a securities exchange facility, and a fraudulent scheme or untrue or misleading statement. Case law has further clarified the prerequisites for a 10b-5 action by a private party, and has established that the plaintiff must have been the purchaser or seller of a security, that the deceptive conduct must have occurred in connection with the purchase or sale of the security, and that the defendant or defendants must have acted with scienter. *See generally* T. Hazen, The Law of Securities Regulation § 13.2 (1985).

With respect to appellant Werner, the evidence of a 10b-5 violation is overwhelming. Werner repeatedly used the telephone, an instrumentality of interstate commerce, to induce Freschi to invest in Grand Coal Venture. In so doing, he misrepresented to Freschi that the prior Spruce Productions offering was withdrawn because of tax problems. This was a lie, and Werner knew it. The evidence

establishes that Werner withdrew the Spruce Productions offering because he was under a court order not to market it. It further establishes that the court order stemmed from activities by a client of Werner's in marketing a similar offering which had aroused the suspicion of the SEC.[2] Werner asserts that the misinformation he gave Freschi and the information he failed to give Freschi were not material. This contention is frivolous. Any reasonable investor would be interested in knowing that the SEC was concerned about possible fraud in connection with a securities offering which the offeror himself described as "basically similar" to the one under consideration for investment. Indeed, if Werner did not consider the fact important, it is difficult to understand why he found it necessary to lie to Freschi about it. Werner not only gave Freschi a false reason for the change in the leases being offered, but failed to tell Freschi that the source of the new leases was an individual the SEC suspected of fraud. We cannot find that it was unreasonable for the jury to consider these misstatements and omissions material; in fact, we are inclined to think that it would have been unreasonable for the jury to have done otherwise.

Werner's argument that he acted without scienter is just as frivolous. Werner knew that the reasons he gave for the change in the offering were not true, and he knew about the court order which was the real reason for the

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[2] In *SEC* v. *American Bd. of Trade, Inc.*, 751 F.2d 529, 540-41 (2d Cir. 1984), we held that it was not improper for the defendant in that action to fail to disclose the existence of a preliminary injunction against it to potential investors. The circumstances of that case were very different, however; as we specifically noted, the preliminary injunction in that case was prompted, not by intentional misconduct, but by a bona fide disagreement between defendant and the SEC as to the interpretation of very technical regulations.

change: indeed, he had been personally served with a copy of it when he made the false and misleading statements to Freschi.

The only remaining issue with respect to Werner's 10b-5 liability, then, is whether Freschi relied on his statements and whether such reliance was reasonable. Freschi testified that he relied on Werner's statements in making the investment decisions on behalf of the trust, and the circumstances support his testimony. At the time of Freschi's December 15 conversation with Werner, he had decided to invest the trust's funds in Spruce Productions: the offering, however, had been withdrawn. Four days after the conversation, Freschi authorized his agent to investigate Bandler & Kass and, if satisfied, invest the trust's funds in the replacement offering, Grand Coal Venture. Even without Freschi's testimony, the conclusion that he relied on Werner's assurances in deciding to invest in Grand Coal Venture would be compelling.[10]

The jury was justified in concluding that Freschi's reliance on Werner's statements was reasonable. There was no particular reason for Freschi to suspect that the undertaking was a fraudulent one. No evidence has been presented indicating that Laird's transactions had achieved the sort of notoriety which would have put Freschi on notice that he was dealing with swindlers.

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[10] Appellants contend that the potential profitability of the venture was irrelevant to Freschi's investment decision, as the trust's only interest, they allege, was in finding a tax shelter. Apart from the fact that only bona fide investments are eligible for tax preferences, this argument is rebutted by Freschi's testimony that he was interested in finding an investment offering both tax advantages *and* a reasonable return. The fact that Freschi took steps, after receiving the offering memorandum, to verify that the leased lands did contain coal supports his assertion that he was concerned with the venture's potential for profit.

Appellants suggest that Freschi ought to have made an independent investigation into whether the leased property actually contained coal reserves. There is respected authority suggesting that such investigation by an investor in mining operations is not necessary. *See Securities & Exchange Comm'n* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 862-63 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (considering the existence of a private cause of action for investors misled by company misrepresentations as to the presence of mineral reserves without any suggestion that investors should have made their own geological investigations).

Freschi, moreover, did undertake some independent efforts to verify the soundness of the offering, as noted above: he obtained legal and accounting advice and sent an agent to inspect the offices of Bandler & Kass to determine that it was a legitimate law firm. To assert that Freschi's efforts to verify the information he received were insufficient to make his reliance reasonable is tantamount to asserting that he should have suspected fraud from the start. As we have said, we see nothing to indicate that he should, and we do not think the jury was unreasonable in so viewing the case.

Sylvor and Sherr, law partners of Werner, were actively involved in the preparation of the Grand Coal Venture offering. Each was aware of the devious operations of Laird, and each knew of the T.R.O. against Laird and against themselves as Laird's attorneys. While the evidence against Sylvor and Sherr may not have been as overwhelming as that against Werner, it was not reversible error for the jury to find Rule 10b-5 liability on the basis of their conduct. *See Bloor* v. *Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 62 (2d Cir. 1985).

Bandler & Kass was actively involved in the Grand Coal Venture offering as well. Not only were three of the principals in the venture Bandler & Kass partners who utilized the firm's facilities to market their fraudulent scheme, but Freschi's checks investing funds in the venture were made out to "Bandler & Kass, Special Account," and accepted by the firm for payment to that account. Thus it was not error for the jury to find Bandler & Kass liable under Rule 10b-5. Similarly, the jury did not err in finding 10b-5 liability on the part of Ground Production Corporation, which marketed the Grand Coal Venture units.

Defendant-appellant Jack Mitnick was Venture Administrator for Grand Coal Venture. The record is absolutely devoid of any showing that he made any misrepresentations to Freschi, or knowingly assisted anyone else in doing so, before Freschi made the investment in December 1977. Since a misrepresentation is actionable under Rule 10b-5 only if it is made in the course of the purchase or sale of a security, Mitnick cannot be held liable for a 10b-5 violation. The judgment to the contrary must be reversed.[11]

Defendant-appellant Baker's role was essentially that of a middleman conveying the leases from Laird to Werner, Sylvor and Sherr. The record establishes that Baker supplied Laird with false geological reports and that the sponsors of the Spruce Productions offering made use of those reports in preparing their prospectus. Baker submitted reports, as president of a consulting firm called

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[11] Mitnick's conduct as Venture Administrator arguably violated his fiduciary duties to the investors. He was not held liable, however, under any such theory. As noted below, the jury properly held Mitnick liable for fraud.

Mineral Resources Development, giving Grand Coal Venture his opinion that the leased land contained large quantities of coal reserves. These opinions, of course, turned out to be erroneous. There is evidence, moreover, that Baker knew these representations to be false or acted with reckless disregard as to their truth. For example, his reports indicated that sub-bituminous coal was available on leased land in North Dakota, while it is a well-known fact in geological circles (as an expert witness testified) that there is no sub-bituminous coal in North Dakota. In addition, there were other misrepresentations in Baker's report. For example, he took advantage of the fact that one of his staff geologists had recently married, and therefore changed her name, to give the impression that her reports before and after the marriage represented the independent findings of two different geologists. The evidence also suggests that he overrepresented his own geological qualifications. All of these representations, moreover, were made to the parties marketing Grand Coal Venture prior to the time Freschi made his investment. Although the case as to Baker's liability is a closer one than that as to the other defendants, we think that there was enough evidence for the jury at least to have found Baker to be a knowing aider and abettor of the 10b-5 violations. Accordingly, we do not reverse the judgment as to Baker.

We now turn to the common law fraud count, on which the jury found all defendants except Sherr liable. The parties agree that the substantive law governing this count is that of New York. As we noted in *Mallis v. Bankers Trust Co.*, 615 F.2d 68 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981), the elements of fraud in New York are representation of a material fact, falsity of that representation, scienter, reliance, and damages.

Id. at 80 (*citing JoAnn Homes* v. *Devorety*, 25 N.Y.2d 112, 119, 302 N.Y.S.2d 799, 803 (1969) and 24 N.Y. Jur., Fraud & Deceit § 14 at 47-48 (1962)). We have discussed all these points in connection with the 10b-5 claim, and it would be repetitious for us to engage in separate discussion here. Our prior discussion of why the jury's findings of 10b-5 liability as to Werner, Sylvor, Baker, Ground Production Corporation, and Bandler & Kass were proper makes it sufficiently clear why the jury was also justified in finding these parties liable for fraud. We further note that while we reversed the finding of 10b-5 liability as to Mitnick, on the ground that he did not make any misrepresentations prior to Freschi's investment, the record amply demonstrates that he committed fraud by his misrepresentations to Freschi in the course of his administration of the investment, by which he attempted to conceal the worthlessness of Freschi's investment from him. For example, Mitnick signed letters dated August 22, 1978 and March 31, 1979 making representations to participants about Grand Coal Venture's attempts to obtain substitute coal-producing properties. These were knowing false representations on which Freschi relied. He was harmed by these statements, in that they prevented him from taking action sooner to recover his money. Accordingly, we affirm the finding of liability as to Mitnick on the fraud count.

The final contention of appellants we must address with respect to the findings of liability is that the court committed reversible error by allowing plaintiff's counsel, in closing argument, to refer to Freschi's belief that his leases guaranteed him replacement properties, in spite of the fact that the court had ruled that Freschi could not reasonably have held such a belief. We fail to see how appellants could have been prejudiced by this argument

The heart of the fraud consisted of the misrepresentations concerning the substitution of Grand Coal Venture for Spruce Productions and the attendant cover-up as to the Laird connection and the temporary restraining order. The evidence as to these misrepresentations was overwhelming, and would have been no less so without counsel's argument on an extraneous issue.

We turn now to the question of damages. There is no question that the trust lost its entire investment, the amount of which was $266,500. Before we determine the amount of the trust's damages, however, we have to consider the effect of any tax consequences. First, we must consider whether the trust's damages must be reduced by any tax deduction obtained as a result of the loss, in light of the principles we recently announced in *Salcer*, 744 F.2d at 935. Second, we must consider whether Freschi is entitled, as he argues on cross-appeal, to damages as a result of any adverse tax consequences which he would have avoided if the Grand Coal Venture had been a legitimate tax shelter.

In *Salcer*, we said:

> . . . § 28a of the Exchange Act [15 U.S.C. § 78bb (a)] . . . limits plaintiffs to recovery of their actual net economic loss. . . . In applying § 28(a) we cannot ignore the substantial economic tax benefits bargained for and realized by plaintiffs.

Salcer, supra, at 941. In this case, the trust sustained losses of $266,500 as a result of its investment. Since IRS allowed the trust's beneficiary a $266,500 deduction from ordinary income as a result, however, and since this resulted in a tax savings of $188,682, the trust's actual loss was only $77,818. Application of *Salcer* requires that

this actual net loss constitute Freschi's recovery on behalf of the trust.

Freschi argues, on cross-appeal, that his damages should be increased to compensate the trust for tax savings it would have realized had the full deductions been allowed. The district court correctly held that a Rule 10b-5 plaintiff can be compensated only for actual damages, and that any award in compensation for hoped-for tax savings would be an impermissible award of damages arising from an expectation interest. *See, e.g., Levine* v. *Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971); *Chasins* v. *Smith, Barney & Co., Inc.*, 438 F.2d 1167, 1173 (2d Cir. 1970). Similarly, the trial court noted that the interest and penalties IRS assessed against the senior Freschi were not a consequential damage; rather, they were simply compensation to IRS for the use of money IRS would have had if the senior Freschi had not wrongly withheld it. The interest and penalties were not, the trial court correctly observed, really a damage suffered by the senior Freschi at all, but a return by him of what would otherwise be a windfall resulting from his opportunity to use money to which he was not entitled.

III.

In conclusion, we AFFIRM the jury findings of 10b-5 violations on the part of Werner, Sylvor, Sherr, Baker, Bandler & Kass, and Ground Production Corporation, and the findings of common law fraud as to all the above except Sherr. We REVERSE the jury's finding of liability as to Mitnick on the 10b-5 count, but AFFIRM the judgment against him on the fraud count. We remand, with instructions that the order of remittitur be amended,

so that Freschi is offered a choice between damages of $77,818 (plus pre-judgment interest) [12] and a new trial.

Freschi's cross-appeal asks that, in the event the remittitur is altered, the trial court be instructed to allow him to proceed on legal malpractice, breach of contract, and RICO (18 U.S.C. § 1961 *et seq.*) counts in the event he should elect a new trial. Because we believe that the trial court was correct in granting judgment non obstante veredicto on the first of these counts, directing a verdict for defendants on the second, and denying Freschi leave to amend his complaint to add the third, we deny this request.

The judgment of the district court is affirmed in part and reversed in part. This case is remanded for further proceedings not inconsistent with this opinion.[13]

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[12] In awarding pre-judgment interest only on $77,818, we are assuming that IRS, in charging Freschi interest on the taxes it determined he owed, did not charge interest on tax payments withheld as a result of the $266,500 deduction, which was ultimately allowed. If this assumption is erroneous and IRS did at some point charge Freschi interest on taxes withheld as a result of the $266,500 deduction, pre-judgment interest should be appropriately increased.

[13] Because the attorney-defendants in this case (Werner, Sylvor, Sherr, and Mitnick) committed actions raising serious questions as to their professional integrity, and because it is not clear from the record exactly what disciplinary action has been taken against them, we instruct the clerk to send copies of this opinion to the appropriate professional conduct review committees.